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L	FBO	AID
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ARMY	CIA	NAVY
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HANDLING INDICATOR

TO : BEIRUT, CAIRO, DHAHRAN, KUWAIT, JIDDA, TEHRAN,
LAGOS, LUANDA, LIBREVILLE, DJAKARTA, CARACAS
-TRIPOLI, BENGHAZI, ALGIERS, ALL OECD CAPITALS,
USEC BRUSSELS, USNATO, USEC

FROM : Department of State

SUBJECT: Effect of Oil Settlements in Libya

REF :

DEPARTMENT OF STATE A/CDC/MR	
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Most companies producing oil in Libya have agreed to major increases in the amount of taxes and royalties per barrel they will pay the Libyan government. The principal outline of the agreements is as follows:

A. An immediate posted price (tax reference price) increase of at least 30 cents per barrel;

B. An effective price increase retroactive to January 1, 1965. However, rather than pay a lump sum settlement for the back payments due under this agreement, companies have agreed to increases in the tax rate from 50 percent to between 54 and 58 percent, depending on the calculation of the size of retroactive taxes due and other factors;

C. A progressive increase in the posted price of 10 cents at the rate of two cents per year until 1975. This is in addition to the immediate 30 cent increase.

The effect of these changes will mean an increase in the tax plus royalty "take" per barrel by the Libyan government of around 25 to 30 cents per barrel. The agreements are effective as of September 1, 1970. At Libya's present rate of production of about 3 million barrels per day, and assuming a 30 cent increase in government

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E:ORF:FSE:WClark:wz	10/15/70	E/FSE - James E. AKINS
Clearances: EUR/RPE - Mr. Shaw AF/N - Mr. Blake		
NEA/RA - Mr. Sandman AF/EPs - Mr. Courtney L/E - Mr. Lieblich		

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income per barrel, Libyan government revenue will be about \$327 million more per year than it otherwise would have been. With a 25 cent per barrel increase in government take per barrel, Libyan revenue will still be about \$274 million higher than it would have been on the same volume of production.

Effects on Producing Countries in Africa and the Middle East

We expect the oil companies will initially maintain that these increases are applicable only to Libya because of its special advantages of location close to markets and the high quality of its oil. It would appear, however, that the pressure on companies for similar settlements by other producing countries in Africa and the Middle East will be irresistible.

Africa

The largest and most immediate effects of the settlements in Libya should be on oil revenues elsewhere in West Africa. Because of its similar location and quality advantages, and especially because of the "most favored African country" clause in concession agreements, there may be an increase in per barrel revenue for Nigeria almost as large as the increase for Libya. At an annual rate of production of 1.2 million barrels per day, an increase in per barrel revenue of 25 cents for Nigeria would mean an increase of about \$110 million in annual government revenue.

Middle East

It seems probable that revenue increases agreed upon in Libya will result in at least some increases in the Persian Gulf as well. Immediate and/or progressive increases in the tax rates and posted prices in the Persian Gulf could increase government revenues by 5 to 20 cents per barrel. Posted prices for oil delivered to eastern Mediterranean pipeline terminals has already been increased 20 cents by some companies.

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Below is a table showing the increase in government revenues assuming various rates of increase in per barrel revenue at an annual rate of production identical to the August, 1970 rate:

	August 1970 annual rate of production in millions of b/d*	Increase in annual revenue in millions of dollars			
		@5¢/bbl	@10¢/bbl	@15¢/bbl	@20¢/bbl
Iran	4.0	\$ 73	\$145	\$219	\$291
Saudi Arabia **	3.8	69	139	208	277
Kuwait **	3.2	58	117	175	234
Iraq	1.5	27	55	82	109
Abu Dhabi	.8	15	29	44	58
Qatar	.3	5	11	16	22
Bahrain	.08	1	3	4	6
Dubai	.08	1	3	4	6
TOTAL		\$249	\$502	\$752	\$1,003

*Source: "Petroleum Intelligence Weekly", September 28, 1970

** Includes share of neutral zone production.

Effect on Consuming Countries

The effect on prices in consuming countries in Western Europe and the Far East of the settlement in Libya by itself would not be very great, although there may continue to be price increases due to other factors, such as transportation costs. If the cost to oil companies of all crude produced in the Eastern Hemisphere went up by 30 cents per barrel (an unlikely event) this would raise overall costs by less than one cent per gallon (30 cent price increase divided by 42 gallons per barrel).

Aggregate cost increases would nevertheless not be insignificant. Assuming a 30 cent per barrel increase in costs in Libya and Nigeria, and a 15 cent per barrel increase for Persian Gulf producers, the fob costs of such oil will go up a total of \$1.2 billion.

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Reallocation of Resources and Balance of Payments Effects

The most immediate obvious effect of the Libyan settlement will be a shift of financial resources from developed oil consuming countries in the eastern hemisphere to the oil producing countries. Some producing countries such as Nigeria, Saudi Arabia and Iran can make immediate use of the new funds by increasing imports; others such as Kuwait and Libya may only increase their London bank accounts and investment portfolios.

It is difficult to assess the net effects of the Libyan settlements will have on the US balance of payments. To the extent that profit margins of US oil companies are reduced by the Libyan settlements, there would be fewer profits to repatriate to help the US balance of payments. It is not clear the degree to which companies will be able to pass on cost increases to customers and consequently the effect the settlements will have on profits, but it would appear that profit margins will be reduced somewhat, at least in the short run.

Effects on Energy Costs and Competition

Before recent market distortions caused by the current shortage of tankers, and other factors, the price of crude oil delivered in Western Europe was about \$2.00 to \$2.25 per barrel, in contrast to a price of about \$3.30 to \$3.45 per barrel for oil produced in the US delivered to the east coast. Many claim that access to cheaper energy sources has given European producers an advantage over goods produced in the United States, particularly in certain industries such as petrochemicals. The Libyan settlements will increase energy costs to Europe (and probably to Japan) and could reduce whatever competitive advantage those areas enjoy over the US because of access to lower cost oil.

Effects on Oil Concession Contracts

The Libyan settlements are the latest of a series of jolting changes in the contractual relationships between producing oil companies and host governments, changes which

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will no doubt continue.

To mention only highlights, contracts in the Middle East first only provided for a modest royalty per barrel. In the 1950's this was changed to the "50-50" profit split, whereby putative profits were calculated by taking the posted price for the oil, which was at or near the market price, deducting the costs of production, and giving the host governments 50 percent of the remainder. Following some reductions in the posted price because of declining market prices, the Organization of Petroleum Export Countries (OPEC) was formed in 1960. OPEC succeeded in getting the posted prices fixed, so that as market prices for oil fell in the 1960's, the amount of tax per barrel was not reduced, and the effective "profit" split became 60 or 70 percent or more in favor of the producing country rather than 50-50. As market prices fell fixed posted prices lost any relationship to real prices and became in effect only tax rate on the putative profits was retained.

Royalties continued, usually to be calculated at 12.5% of the posted price, but were all deducted from the tax due, so that the "take" per barrel by host governments was still only 50% of the putative profits. In 1965 producing countries, led by Libya, succeeded in revising contracts to allow for royalty expensing - that is, to count royalties as an expense and deductible from taxable income, rather than as deductible from the tax. The effect of royalty expensing was to increase government "take" per barrel by about half of the amount of the royalty. This increased revenue per barrel of about 10%. However the tax rate still remained only 50%.

The oil companies in Libya have now opted to abandon the 50 percent tax rate rather than make huge cash settlements for retroactive posted price increases which the Libyans were demanding. Oil companies will no doubt try to keep the 50 percent tax rate elsewhere if they can, saying that it is only applicable to the special circumstances prevailing in Libya, but it is doubtful they will be able to hold the line.

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Future Trends

It is impossible to say what contractual relations in 5 or 10 years will be between oil companies and governments of producing countries except that they will doubtless be different from what exists today. How different they will be is hard to say. The Shah of Iran said recently in a press interview:

"Producing oil is not difficult. We are already doing it...We can drill wells and fill tankers. Why should foreign companies do it?... In a few years, things will happen like this: the tankers will come, will buy oil directly from the producing countries, and will leave. The whole present system of exploiting companies must disappear."

Leaders of other oil producing countries, notably Saudi Arabian Petroleum Minister Ahmad Zaki Yamani, have said that the goal of oil producing countries should be "participation" in oil company operations. Depending on the speaker, participation can mean either an equity share in oil operations within the producing country, a share in downstream oil operations of transporting, refining, and marketing oil, or both. The method whereby countries would gain such equity participation has not been spelled out.

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